Information Request DTE 1-12

Refer to page 9 of the Marshall testimony. Explain the difference in the tax treatment accorded to stock dividends versus cash dividends. As part of this response, explain the term "basis" in the stock as used by the Company.

Response

Under the IRS code of regulations (the "IRC"), cash-dividend payments are treated as taxable income to the shareholder upon receipt (IRC Section 301(a),(c)). Stock dividends are not taxable to shareholders when received because stock dividends do not provide income to the recipient. (IRC Section 305(a)). When shareholders receive a stock dividend rather than a cash dividend, there is no taxable event until the shareholder decides to sell his or her shares of stock. Therefore, for the Company's shareholders there is a significant tax advantage because the shareholders have control over the 'taxable event' associated with any dividends received on the shares that they hold.

The term "basis" refers to the amount of the shareholder's investment in the shares of stock. Specifically, when the number of shares held by a stockholder are increased through the receipt of a stock dividend, the total investment originally made by the shareholder in his or her existing shares is then extended to the new shares of stock on a pro rata basis for income taxation purposes (IRC Section 307(a)). For example, a shareholder may own 100 shares of common stock purchased at $12.00 per share for a total investment of $1,200. The shareholder's "basis" is $12.00 per share. A 5 percent stock dividend would provide the shareholder with 5 additional shares. After the stock dividend, the "cost basis" of each share of stock (old and new) would be $11.43 or $1,200 divided by 105 shares. If and when the shareholder sells the shares of stock, the shareholder will pay taxes on any difference between the selling price and the then-existing "basis" in each share of stock.

The relevant sections of the Internal Revenue Code are as follows:

§ 305 Distributions of Stock and Stock Rights

(a) General rule.

Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.

§ 301 Distributions of Property.

(a) In general.

Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c) .

(b) Amount distributed.

(1) General rule.

For purposes of this section, the amount of any distribution shall be the amount of money received, plus the fair market value of the other property received.

(2) Reduction for liabilities.

The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by-

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) Determination of fair market value.

For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) Amount taxable.

In the case of a distribution to which subsection (a) applies-

(1) Amount constituting dividend.

That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis.

That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.

(A) In general.

Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions out of increase in value accrued before March 1, 1913. That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

§ 307 Basis of stock and stock rights acquired in distributions.

(a) General rule.

If a shareholder in a corporation receives its stock or rights to acquire its stock (referred to in this subsection as “new stock”) in a distribution to which section 305(a) applies, then the basis of such new stock and of the stock with respect to which it is distributed (referred to in this section as “old stock”), respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock. Such allocation shall be made under regulations prescribed by the Secretary.